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Research Update:

Frontier Communications Corp. Ratings Lowered To 'BB-' From 'BB'; Outlook Stable

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Overview

- U.S. incumbent local exchange carrier Frontier Communications Corp.'s operating and financial performance has been constrained by cable telephony competition and wireless substitution.
- We have revised our assessment of the company's financial risk profile to "aggressive" from "significant".
- As a result, we are lowering our corporate credit and senior unsecured debt ratings to 'BB-' from 'BB'.
- The stable outlook reflects our expectation that Frontier will be able to maintain leverage in the low-4x area.

Rating Action

On Jan. 25, 2013, Standard & Poor's Ratings Services lowered its corporate credit and senior unsecured debt ratings on Stamford, Conn.-based incumbent local exchange carrier (ILEC) Frontier Communications Corp. (Frontier) to 'BB-' from 'BB'. The '3' recovery ratings are unchanged. The outlook is stable.

Rationale

The downgrade reflects our reassessment of the company's financial risk profile to "aggressive" from "significant". We now expect that Frontier's leverage will remain at or above 4x and its funds from operation (FFO) to total debt will remain below 20% over the next few years due to a likely decline in EBITDA during this timeframe. Our previous rating incorporated the expectation that leverage would decline to the low-3x area by the end of 2012.

Cable telephony competition and wireless substitution continue to hurt Frontier's operating and financial performance. During the third quarter of 2012, total revenue and EBITDA fell 3% and 5%, respectively, year-over-year, due primarily to annual access line losses of about 8% as well as declining subsidy revenue. We expect this trend to continue over the next few years, which will make it challenging for the company to improve key credit measures, despite its plan to pay down absolute levels of debt with free operating cash flow (FOCF). Moreover, we estimate that after its dividend, discretionary cash flow only represents about 5% of Frontier's total debt burden, which suggests that it will be difficult to meaningfully reduce debt without lowering the dividend.

Our base-case scenario incorporates some of the following assumptions:

- Residential access lines decline around 9% to 10% annually due to ongoing competitive pressures from cable operators and due to wireless substitution.
- Business access lines decline around 5% annually due primarily to competition from the cable providers in the small and midsize business segment.
- The number of digital subscriber line (DSL) customers is flat in 2013 versus 2012 as that product matures and begins to decline thereafter due to market share losses to cable and long-term evolution (LTE) wireless services longer term as more customers opt to "cut the chord". However, we expect pricing on DSL services to increase because of higher bandwidth demand.
- Total revenues and EBITDA decline around 3% to 5% annually although we expect some margin improvement in 2013 as a result of cost savings initiatives.
- The company generates about \$850 million of FOCF in 2013 and \$770 million in 2014, of which about \$400 million is consumed by the dividend.
- Leverage remains above 4x over the next couple of years.

The ratings on Frontier reflect a "weak" business risk profile and "aggressive" financial risk profile. Key business risk factors include stiff competition from the incumbent cable operators, which are bundling telephone with high-speed data (HSD) and video services and increasingly targeting smaller business customers, as well as from wireless substitution. Other business risk factors include Standard & Poor's Ratings Services' expectation for declining revenue from federal and state subsidies due to regulatory changes, which is partially offset by higher subscriber line charges, and the likelihood of continued weak operating performance in the acquired Verizon properties. Tempering factors include the company's solid position as an incumbent in its legacy markets, healthy EBITDA margins and solid FOCF, and still modest growth from data services.

Frontier is an ILEC with about 4.9 million access lines, largely in rural areas. The company provides services including local access, long distance, and high speed data using DSL technology. It has operations in 27 states, including a heavy concentration in West Virginia, Indiana, and New York, which represents almost one-third of its access line base. As of Sept. 30, 2012, Frontier had about 1.78 million DSL customers and 388,257 video customers. Wireless substitution and cable competition continue to erode Frontier's customer base. Cable providers are bundling telephone service with broadband and video and have been successful in capturing market share. In addition, many consumers, especially in a weak economy, are eliminating wireline service altogether, and we expect more customers to opt out over the next several years. Total access line losses were about 8% in the third quarter of 2012, year over year, and are the primary contributor to overall revenue declines. DSL penetration is somewhat lower than that of Frontier's peer group at around 36%, in part due to lower penetration levels in the legacy Verizon markets. Additionally, DSL subscriber growth continues to slow and was about 1.6%,

year-over-year, in the third quarter of 2012. We believe that longer term growth prospects are largely uncertain given DSL's distance and speed limitations, which may make it difficult for Frontier to compete with cable broadband for residential customers as data demand increases.

In July 2010, Frontier acquired about 4 million access lines from Verizon Communications. The company was able to successfully integrate the acquired properties, achieve its target of \$650 million of cost synergies, and improve broadband availability, which was low at about 60% prior to the acquisition. While Frontier achieved modest improvement in operating performance, it is still weak, including annual access line losses of around 9% in these markets. Moreover, we believe it will be difficult for Frontier to meaningfully improve performance in these markets because the incumbent cable operators already have a dominant market share.

We consider the financial risk profile "aggressive," based on the company's leverage and substantial dividend payout. Total debt to last-12-month EBITDA as of Sept. 30, 2012, was about 4.0x. We believe that EBITDA will decline in 2013 and beyond as access-line losses continue, making it harder for Frontier to improve credit measures despite our expectation for ongoing debt paydowns. The reported EBITDA margin is healthy, at about 46% as of the third quarter of 2012, and is modestly better than that of its peers. While we believe that the company will successfully reduce costs further in 2013, secular industry declines and competitive pressures could lead to lower margins in later years.

Liquidity

We consider liquidity "adequate". Cash sources consist of about \$1.1 billion of cash as of Sept. 30, 2012, of which \$503 million was used to repay debt in January 2013, an undrawn \$750 million revolving credit facility, and our expectation that it will generate around \$1.5 billion of FFO in 2013. Uses of cash are at least \$650 million of capital expenditures, a sizable common dividend of around \$400 million, and debt maturities of \$57 million in 2013. In line with our criteria for the adequate assessment, we expect sources of liquidity to exceed uses by about 2.5x over the next year and net sources to remain positive, even with a 15% to 20% drop in EBITDA.

Frontier's \$575 million senior unsecured term loan and \$750 million revolving credit facility have a net debt to EBITDA covenant of 4.5x through the term of the agreement. Leverage under both the revolver and term loan is calculated after subtracting cash in excess of \$50 million from debt. We expect that Frontier will maintain more than a 25% cushion under these covenants, which we associate with adequate liquidity.

Recovery analysis

For the recovery analysis, see the recovery report to be published on RatingsDirect following release of this article.

Outlook

The outlook is stable and reflects our expectation that Frontier will be able to maintain leverage in the low-4x area. We expect the company will use FOCF to repay debt. However, we expect ongoing access line losses and slowing DSL growth to pressure EBITDA levels and therefore constrain the company's ability to reduce debt. The company's significant ongoing dividend also limits prospects for substantial debt reduction.

We could lower the ratings if operating trends deteriorate--for example, if access line losses were to spike higher or if revenue from business services declined more than we expect due to market share losses to cable, and result in leverage that approaches 5x. In addition, a large debt-financed acquisition which pushes leverage to the 5x area with no realistic path to longer-term leverage improvement could prompt a ratings downgrade.

Although unlikely in the near term given Frontier's aggressive financial policy and our view of the business risk profile as "weak," we could raise the ratings if Frontier can improve operating trends, including a meaningful improvement in access line levels and growth in revenue from data services, which prompts a revision of our business risk profile to "fair" and contributes to an improvement in leverage to the low-3x area.

Related Criteria And Research

- Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Guidelines For Recovery Ratings, Aug. 10, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008

Ratings List

Downgraded; Outlook Action; Recovery Ratings Unchanged

	To	From
Frontier Communications Corp.		
Corporate Credit Rating	BB-/Stable/--	BB/Negative/--
Senior Unsecured	BB-	BB
Recovery Rating	3	3
Frontier North Inc.		
Senior Unsecured	BB-	BB
Recovery Rating	3	3

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Frontier West Virginia Inc.

Senior Unsecured	BB-	BB
Recovery Rating	3	3

Ratings Affirmed; Recovery Ratings Unchanged

Frontier North Inc.

Senior Unsecured	BBB/Developing
Recovery Rating	3

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